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Brazil: Unorthodox Economic Policies Take Their Toll

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An Intelligence Assessment

PROJECT NUMBER ALA-2623-88 N

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PAGE NUMBERS 16

TOTAL NUMBER OF COPIES 460

DISSEM DATE 880412

EXTRA COPIES 347-371

RECORD CENTER 372-421

JOB NUMBER 425-566-88

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An Intelligence Assessment

This paper was prepared by [redacted] Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, South America Division [redacted] 25X1

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Brazil: Unorthodox Economic Policies Take Their Toll

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Scope Note

Information available as of 24 March 1988 was used in this report.

This study is part of a continuing effort within the Directorate of Intelligence to scrutinize the Brazilian economy and the implications of its problems for the United States. 25X1

Building on US Embassy reporting and material from a wide variety of highly regarded Brazilian journals, this paper reviews the Sarney government's economic and financial strategies over the past year and their repercussions. It then examines the debt negotiations and recent economic management efforts, concluding with an assessment of prospects over the next year and beyond and highlighting the implications for both Brazil and the United States. 25X1

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Brazil: Unorthodox Economic Policies Take Their Toll

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Key Judgments

Brasilia's chaotic approach to economic and financial policy through most of 1987—the result of weak leadership and mismanagement—has sent the economy into a tailspin. Ignoring repeated calls from the private sector for sharply lower government expenditures, the Sarney government has instead resorted to price controls and wage restraint to fight inflation, periodically announcing cosmetic spending cuts but often failing to implement them. Simultaneously, Brasilia's moratorium on interest payments to commercial creditors, declared in February 1987, and its refusal to implement an International Monetary Fund (IMF) program have cost it access to financing from both commercial and official creditors. As a result, the economy turned in sharply lower real growth of 2.9 percent last year—down from 8 percent in 1986 and well below the 6 percent needed to generate jobs for new entrants to the labor force. At the same time, inflation—even with price controls for part of the year—reached nearly 370 percent. 25X1

President Sarney began 1988 with promises of reform and with a new, more competent economic team, but the government remains saddled with political constraints that, in our view, will prevent major headway toward economic stabilization this year. The administration lacks dependable, broad political support, and both the Constituent Assembly and Sarney remain preoccupied with key provisions of the new constitution, especially the length of the President's term. 25X1

Under these circumstances, Sarney has been unable or unwilling to rein in government spending. We expect him to continue to spread federal largess to gain political support as long as the debate over the length of his term goes on. Thus, we see little likelihood that even a competent economic team can enforce the discipline needed for significant deficit reduction, which in turn is imperative to break expectations of accelerating inflation and to restore private-sector confidence. 25X1

Against this backdrop, inflation will probably rise to 500 percent or more, while investment drops. No real growth is likely, and the economy may well experience a recession. Living standards are apt to erode further, and expressions of social discontent, such as strikes, protests, supermarket lootings, and street crime, probably will rise. 25X1

Current political circumstances probably make unlikely the alternative that Brasilia would follow through on promises of strict fiscal austerity this

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year. Even so, if Sarney finally gains a five-year term, he may follow through with austerity measures. This would put the economy on a track toward higher growth and lower inflation. 25X1

It is possible, though less likely, that the economy will take a steep plunge in 1988. Brasilia could lose all control over spending as Sarney pays off political debts incurred to secure his term. This would prompt even looser monetary policies than we now foresee, potentially leading to hyperinflation and serious social unrest. 25X1

The single bright spot on the economic horizon in 1988 is the external sector. Brazil and its foreign commercial creditors appear intent on reaching a multiyear debt rescheduling and new money package, with both sides more willing to make concessions now than in the past. Brazil has slashed its new money request in half to $5.8 billion and promised to implement an IMF program by mid-June. For their part, banks seem likely to concede that disbursements of money not be linked—as is customary—to meeting IMF-mandated economic performance targets. Brazil's ultimate balance-of-payments position will depend on whether the debt agreement and IMF accords are concluded, but a healthy trade surplus should reduce the external payments gap this year. While such agreements should result in increased flows of foreign funds to Brazil, they are likely to do little to stem economic deterioration. 25X1

We see little chance for a significant improvement in Brasilia's strained economic relationship with the United States this year, despite progress on debt and recent movement on Brazil's restrictive trade practices, both of which have created friction with Washington. In the face of a still-somber economic outlook and continuing political uncertainty, we believe Brasilia will expect Washington to make fewer economic demands and to assist Brazil in its efforts to obtain favorable accords with the IMF and commercial creditors. This is likely to be difficult because a number of other potentially contentious bilateral trade and investment issues loom ahead. 25X1

Sarney's successor will face immense economic and social hurdles—far beyond the immediate, urgent problems of inflation and debt. Major structural reforms are needed to reduce the government's role in the economy and encourage the domestic savings and investment necessary to support sustained future growth. Without immediate, substantial new investments, potentially serious bottlenecks in Brazil's economic infrastructure are likely by the turn of the decade. In addition, much of the industrial sector is becoming increasingly obsolete because modernization plans have been stymied by laws that prohibit the import and copyright protection of most computer products. Finally, any new president must alleviate serious social inequities if he is to increase the productivity of the country's human resources. 25X1

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Brazil: Unorthodox Economic Policies Take Their Toll [redacted]

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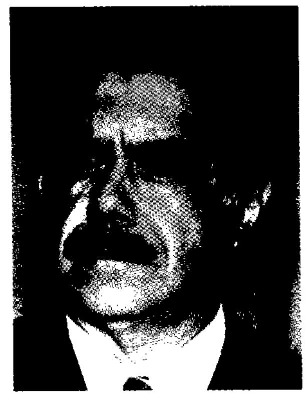
Introduction

One year after unilaterally declaring a moratorium on interest payments on its $68 billion debt to commercial banks and becoming increasingly isolated in the international financial system, Brazil now appears to be reentering the fold. Although Brazil's economy and the international banking system have weathered the payments suspension without immediate dire consequences, the moratorium has taken its toll on the health of both. Moreover, the government of President Jose Sarney has taken an unorthodox approach to economic management over the past two years—by relying on price controls, heavy government intervention in the economy, and increasingly nationalistic policies. This has paralyzed domestic savings and investment, pushed inflation to record levels, and driven out foreign investors. Brazil's ability to generate growth and employment has been seriously impaired despite an enormous array of assets—including vast arable land, still-untapped natural resources, a large internal market, a diversified economy and export base, and a dynamic, enterprising business sector. Should the government continue along its recent path, the likely result would be severe political, economic, and social consequences for the non-Communist world's eighth-largest economy and the Third World's largest debtor. [redacted]



President Jose Sarney [redacted]

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Chaotic and Confrontational Policies

Stop-and-Go Economic Management

An ad hoc, frequently inconsistent, approach to economic policy through much of 1987 has brought Brazil to the brink of hyperinflation and recession. During the first six months of 1987, the Sarney government allowed economic policy to drift. President Sarney's popularity eroded rapidly during this period as his earlier temporary success in stopping rapid inflation and maintaining a consumption-led economic boom came undone. At the same time, the economic team responsible for the 1986 Cruzado Plan disintegrated; both Minister of Planning Joao Sayad and Central Bank President Fernao Bracher resigned after their proposals for economic stabilization were rejected by then Finance Minister Dilson Funaro. [redacted]

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The President, indecisive, untrained in economic matters, and preoccupied with his sagging popularity, deferred key economic decisions. Although he permitted much-needed price increases during this period, he ignored advice from domestic businessmen to adopt a comprehensive economic program that would bring down escalating inflation, encourage investment, and reduce government red ink. Instead, Sarney reintroduced indexation of wages and financial assets to blunt the impact of inflation on living standards, while publicly blaming the private sector for escalating inflation and accusing it of being too irresponsible to operate in an economy without price controls. Despite promises of fiscal austerity, Brasilia took no concrete steps to rein in chronic government deficit spending—the root cause of inflation in Brazil. In fact, Sarney in April 1987 established special lines of credit to farmers and small businesses to forestall the growing number of bankruptcies, and he dispatched increased federal largess to troubled state and municipal governments in an attempt to buy political support. [redacted]

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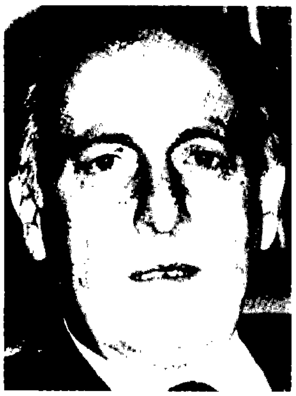

Luis Carlos Bresser, Finance Minister, April-December 1987 [redacted]

When such economic disarray sent inflation spiraling out of control by midyear, Brasilia announced another price freeze and more plans to cut government spending. On the surface, this new program—dubbed the Bresser Plan after Finance Minister Luis Carlos Bresser Pereira—was more sound than previous attempts at economic stabilization by the Sarney government. But, despite its success in bringing inflation down temporarily, it eventually fell victim to the same fate as the Cruzado Plan, unraveling because of a lack of political will to implement deficit reduction. [redacted] 25X1

[redacted] President Sarney consistently undermined Bresser's efforts to pare government spending by dispensing costly favors in an attempt to sway the Constituent Assembly against limiting his term to four years. While Brazilian politicians have long relied on patronage to secure votes, and although budget deficits have plagued Brazil for more than a decade, the extent and impact of both worsened in 1987. By October, Brazil's private sector had largely concluded that the government was reneging on its promises. As businessmen responded by largely ignoring the Bresser Plan's remaining price controls and wage guidelines, inflation took off again late in the year. [redacted] 25X1

Brazil's Debt Moratorium

Brasilia did undertake one major initiative in early 1987, halting interest payments on 20 February on its $68 billion medium- and long-term commercial debt—an action which, in retrospect, gained the Sarney government little. A variety of factors led President Sarney to announce the suspension:

- Foreign exchange reserves were depleted because of a plunge in what had been a healthy trade surplus.

The Political Backdrop

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Two decades of military rule left Brazil's political system without the strong parties, institutions, and civilian leaders needed to guide the transition to democracy. Complicating this, President Sarney [redacted] *has no real mandate, having come to office only as a result of the unexpected death of President-elect Tancredo Neves. The President, originally from a right-of-center promilitary party, has faced intense pressure from the center-left Democratic Movement Party (PMDB) since taking office.* [redacted] 25X6 25X6 25X6 25X1

The PMDB now holds a majority in Congress, the Cabinet, and state governorships, and it has taken an increasingly active role in setting policy, particularly in 1987 when the Constituent Assembly—formed by the members of Congress—began work on a new constitution. Leftists in the PMDB spearheaded debates over the length of Sarney's term, advocating that it be shortened to four years rather than the five he lobbied for. The drafters also proposed a mixed presidential-parliamentary system of government, scrapping the strong presidency inherited from the former military regime. Political observers saw this move as an effort to reduce the President's statutory powers and circumvent [redacted] *Sarney by establishing a prime-ministership under the likely control of the PMDB—a system that many believed unworkable. While these contentious issues remained outstanding, decisions on economic and debt policy took a backseat in 1987 and early 1988, being dealt with only in an ad hoc fashion when a crisis seemed imminent.* [redacted] 25X6 25X1

The rapid growth in domestic demand, spurred by the Cruzado Plan's nine-month price freeze and an overvalued currency, had led to lower exports and higher imports in 1986. Brasilia simply could no longer meet scheduled payments.

- Brasilia's preliminary approaches to foreign commercial creditors in late 1986 and early 1987 for emergency financial relief had been rebuffed.

Figure 1. Financial and political calculations; PMDB, PTB, PFL, PT, PL, and PDS are political parties in Brazil. [redacted]

"You're too late...Brazil got it all." 25X1

Figure 2. Cartoon that appeared after Brazil declared the moratorium. [redacted] 25X1

- President Sarney was under intense political pressure to take radical action on the foreign debt and divert public attention from the rapidly deteriorating economy. [redacted]

The cost to Brazil of President Sarney's debt moratorium gamble was numerous financial setbacks and a tarnished reputation abroad. The moratorium also failed to rally support for the government at home, where public opinion polls showed that it was widely viewed as a reflection of failed domestic policies rather than as a demonstration of strength. The foreign exchange savings were insufficient to bolster the economy or preclude the need for austere adjustment measures to correct fundamental imbalances in the economy. In addition, Brasilia's hope that foreign banks—particularly those in the United States, which hold one-third of Brazil's total commercial debt—would be forced to grant concessions by the threat of reduced earnings and the fear that other debtors would join Brazil was quickly shattered. [redacted] 25X1

Banks moved quickly to isolate Brazil by rapidly concluding agreements with other key debtors such as Argentina and the Philippines. Most of the banks had already reclassified their loans to Brazil as nonperforming, long before banking regulations mandated such a move.[1] In May 1987, banks further signaled their unwillingness to be pressured into granting an overly concessionary agreement by setting aside additional reserves against their loans to developing countries. [redacted] 25X1

Moreover, despite Brasilia's attempts to freeze its $15 billion of short-term trade and interbank credits, [redacted] the moratorium cost it 25X1

[1] US banking regulations require that banks place loans on a nonaccrual or nonperforming basis when interest payments become 90 days past due. This prohibits banks from treating interest due as income before it is received. [redacted] 25X1

A Moratorium Without a Game Plan

Most observers expected Brasilia to use the moratorium in 1987 as a negotiating tactic to obtain a quick settlement with commercial creditors. As it turned out, however, the Sarney government's paralysis had extended to the financial arena as well, and Brasilia was slow to define its financial strategy after declaring the moratorium. The Finance Minister traveled to major creditor countries in March and April 1987 to seek support for what he termed a "political" solution to the debt problem, but he avoided substantive discussions with commercial bankers. Brasilia apparently hoped to convince creditor governments, particularly the United States, to change banking and accounting regulations to permit banks to "forgive" a substantial portion of the debt without catastrophic consequences for their equity. It also called on governments to increase their lending to Brazil, both through direct bilateral credits and loans from multilateral development banks. This effort largely failed. [redacted]

Brasilia continued to service its $15 billion in short-term trade and interbank credits, but it took preemptive measures to prevent banks from withdrawing these credits—vital to the conduct of trade and banking operations—in the wake of the moratorium. In addition, Brasilia initially made only halfhearted attempts—tightening import controls and increasing export incentives—to boost its sagging trade surplus, and thereby restore its ability to service its debt. Moreover, Brasilia failed to heed calls from exporters for a major devaluation until mid-1987. Exports finally recovered during the second half of the year on the strength of a newly competitive currency and reduced domestic demand. [redacted] 25X1

Formal negotiations with banks did not begin until late September—seven months into the moratorium. Brasilia initially demanded that banks finance 60 to 70 percent of its interest obligations over three years—a sum equal to over $11 billion—in spite of forecasts that estimated its financial gap at half that amount. The banks, uncomfortable with Brazil's failure to provide details of policies it would implement to stabilize the economy, rejected these proposals. The parties made little headway until late October, when US bank regulators were scheduled to meet to consider downgrading Brazil's debt. That step, if taken, would have required banks to set aside specific reserves against their Brazilian loans, probably cutting Brazil off from any new loans for the foreseeable future. [redacted] 25X1

The US Treasury and the Federal Reserve intervened in October to facilitate an interim agreement covering $4.5 billion of interest arrears for 1987. Brazil agreed to pay $1.5 billion of its interest obligations while banks contributed the remaining $3 billion. One-third of the money was disbursed in December, while release of the remaining two-thirds was tied to the negotiation of a longer term agreement. [redacted] 25X1

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access to as much as $1 billion of these credits. Banks that agreed to roll over short-term credits did so only under more stringent terms—maturity periods shortened from an average of about three months to only two weeks, and interest rates were increased. Thus, while Brasilia's ability to conduct trade was not seriously impaired—the trade surplus rose nearly 35 percent in 1987 over the depressed levels of 1986—the attendant costs rose considerably. [redacted]

Despite the trade surplus rebound and the nonpayment of about $4.5 billion of interest in 1987, Brasilia's foreign exchange reserves were very slow to rebuild. Official statistics, though subject to manipulation, show Brasilia ending the year with $4.4 billion in cash reserves, only $1 billion more than when the

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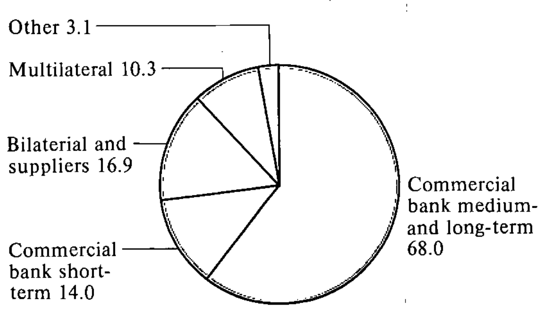
Figure 3
Brazil: External Debt Profile, December 1987[a]

Billion US $



Total: $112.3 billion

[a] Preliminary.

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moratorium began 10 months earlier. The Central Bank expended close to $1 billion to issue import credits to compensate for the loss of external financing. In addition, capital outflows rose as foreign investors increased remittances and scheduled repayments to multilateral institutions increased.

Inflows from development banks also were much lower in 1987 than the government anticipated. While project financing worth several billion dollars was approved, scheduled disbursements were held up because Brasilia failed to meet requirements tied to the loans. Moreover, Brazil did not regain access to medium- and long-term financing from bilateral export credit agencies that was cut off in 1986 in the absence of a formal debt rescheduling accord with the Paris Club of creditor governments. Finally, capital flight appears to have risen somewhat last year, but probably accounted for less than $1 billion in foreign exchange losses, since real interest rates were high for most of the year.

Internal Economy Slows

The economic disarray in 1987 produced a poor environment for productive investment. Volatile but generally high interest rates, a falling stock market, and a record number of bankruptcies were the order of the day. High inflation—nearly 370 percent for the year—eroded real purchasing power by about 25 percent despite wage indexation and large nominal pay hikes in the last quarter of the year for certain sectors. In turn, retail sales and industrial production plunged, ending the consumer boom that had provided for real growth in excess of 8 percent per year in both 1985 and 1986. 25X1

Brasilia hoped that the private sector would lead a recovery of domestic investment, which had been relatively sluggish for five years. But most businessmen—both foreign and domestic—deferred investment in new plant and equipment, opting instead to keep their money in liquid investments producing high rates of return. They cited many reasons, including 25X1 weak consumer demand and the lack of available financing at reasonable interest rates.

The US Consulate in Sao Paulo reports, however, that topping the list of business complaints was concern over economic mismanagement, political uncertainty, and a lack of confidence in the Sarney government's ability to stabilize the economy. This attitude was 25X1 expressed openly by leading businessmen, such as the chairman of the largest car manufacturer in Latin America and the president of a major industrial association in Sao Paulo. Moreover, a leading financial journal conducted a survey of the top 500 companies in Brazil that showed the few companies that 25X1 invested did so mainly to expand existing facilities or to diversify product lines, alternatives that permit a relatively rapid rise in sales. Only one-third of new investment went toward the construction of new plants. 25X1

Meanwhile, public-sector investment was virtually stagnant in 1987, although government spending rose about 7 percent in real terms. The National Development Fund that Brasilia established to finance a major share of public-sector projects—through compulsory surcharges on certain goods and mandatory contributions by pension fund portfolios—experienced a shortfall of about $5 billion because of lower-than- 25X1 expected sales of the affected products and the failure

Brazil: Balance of Payments *Billion US $*

	1985	1986	1987 [a]	1988 [b]
Current account	0.3	−4.0	−0.9	−0.5
Trade balance	12.5	8.3	11.1	12.5
Exports	25.6	22.4	26.2	26.5
Imports	13.2	14.1	15.1	14.0
Net services and transfers	−12.2	−12.4	−12.0	−13.0
Interest on debt	−11.2	−10.1	−9.5	−10.0
Capital account	−2.5	−0.9	−2.6	−1.2
Direct investment, net	0.7	−0.1	0.4	0.8
Government and official agencies credit, net [c] [d]	−1.0	−0.9	−2.0	−1.4
Commercial banks and other lending, net [d]	−2.2	0.1	−1.0	−0.6
Financing gap	2.2	4.9	3.5	1.7
Change in reserves	−2.2	−4.9	−0.2	0
Change in arrears	0	0	3.3	1.7
Cash reserves, 31 Dec	7.7	4.6	4.4	4.4
Liquid reserves, 31 Dec	11.6	6.8	8.0	8.0

Note: Because of rounding, components may not add to totals shown.

[a] Preliminary.
[b] Projected.
[c] Includes IMF.
[d] Includes only inflows now programed—thus, does not include possible funds from IMF standby or commercial bank agreements—and assumes Brasilia maintains access to its short-term credit lines.

[redacted] 25X1

of pension funds to meet targets. In addition, Brasilia diverted some existing investment funds to bail out bankrupt state enterprises and governments as well as to service the rapidly growing domestic debt. External funds to finance other projects failed to materialize. [redacted]

As a result, total capital formation tumbled to only 16 percent of GDP—short of Brasilia's target of 19.5 percent, and well below the 24 percent needed to generate sustainable growth of 7 percent per year. Consequently, the economy turned in sharply lower growth in 1987. The 2.9-percent growth was well below the 6 percent necessary to keep pace with the job needs of new entrants to the labor force. [redacted]

Lower growth and increasing unemployment caused real tax revenues to drop 10 percent in 1987. In addition, Brasilia's reluctance to authorize timely rate and fee hikes for some public-sector goods and services—in order to temper inflation—eroded real revenues of state-owned enterprises, which then required infusions from the federal treasury. These factors, combined with increased spending, caused the public-sector deficit to soar to over 6 percent of GDP, the highest level since 1982 and nearly twice Brasilia's

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target of 3.5 percent.[2] With no access to foreign financing to close the gap, Brasilia issued more government bonds, causing the stock of domestic debt to soar 35 percent in real terms. Although the government attempted to follow a relatively tight monetary policy for much of the year to reduce the risk of uncontrollable inflation, by yearend monetary aggregates also were increasing at a rate above inflation.

Challenges in 1988

Sarney began 1988 with a new economic team, Finance Minister Nobrega and Planning Minister Abreu, who have promised to introduce fiscal responsibility, implement an International Monetary Fund (IMF) program, and normalize Brazil's strained relations with the international financial community. The domestic business community welcomed their appointment. According to the US Embassy, both Nobrega and Abreu hope that their lack of association with a political party—Sarney's previous three finance ministers and two planning ministers were members of the majority, left-of-center Brazilian Democratic Movement Party (PMDB)—will allow them more freedom to implement coherent, rational economic policies. But the PMDB's lack of involvement in their selection—reflecting the party's desire to distance itself from economic policy—may cost the new team congressional support at some crucial juncture.

Although foreign creditors were likewise encouraged by the new economic team, the latest round of talks for a multiyear debt rescheduling and new money package got off to a sour start when Brasilia reneged on its commitment—made at the time of the interim agreement in November—to resume interest payments in January. Nobrega claimed that Brazil's foreign exchange reserves were insufficient for it to resume full payments, but when he was again faced with an imminent downgrading of Brazil's debt by US regulators, he agreed in early February to begin making partial payments. Bankers were heartened by Brasilia's more moderate line following the early February payment, especially by Sarney's public admission that the moratorium was a grave error.

Mailson Nobrega, Finance Minister, January 1988-present

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On the political front, Sarney began the year promising to govern independently from the PMDB, which had consistently hemmed him in, and he is now looking to a recently formed center-right grouping in the Constituent Assembly for support. The group's strength and willingness to back Sarney are open to question, however. Sarney continues his drive to remain President through 1989, despite numerous opinion polls showing the overwhelming majority of the public favors an election in 1988. Although the Constituent Assembly decided in late March to set future presidential terms at five years, it is not expected to decide Sarney's term until May or June. While this issue remains unresolved, the ability of the Sarney administration to follow through on major policy changes remains in doubt.

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Outlook: Little Cause for Optimism

More Muddling—and Economic Decline—Ahead

Over the next year or so we see three possible outcomes:

- Continuation of roughly the same unsettled economic situation.
- A grave, though less likely, economic plunge.
- And, also less likely, the beginnings of modest economic reform.

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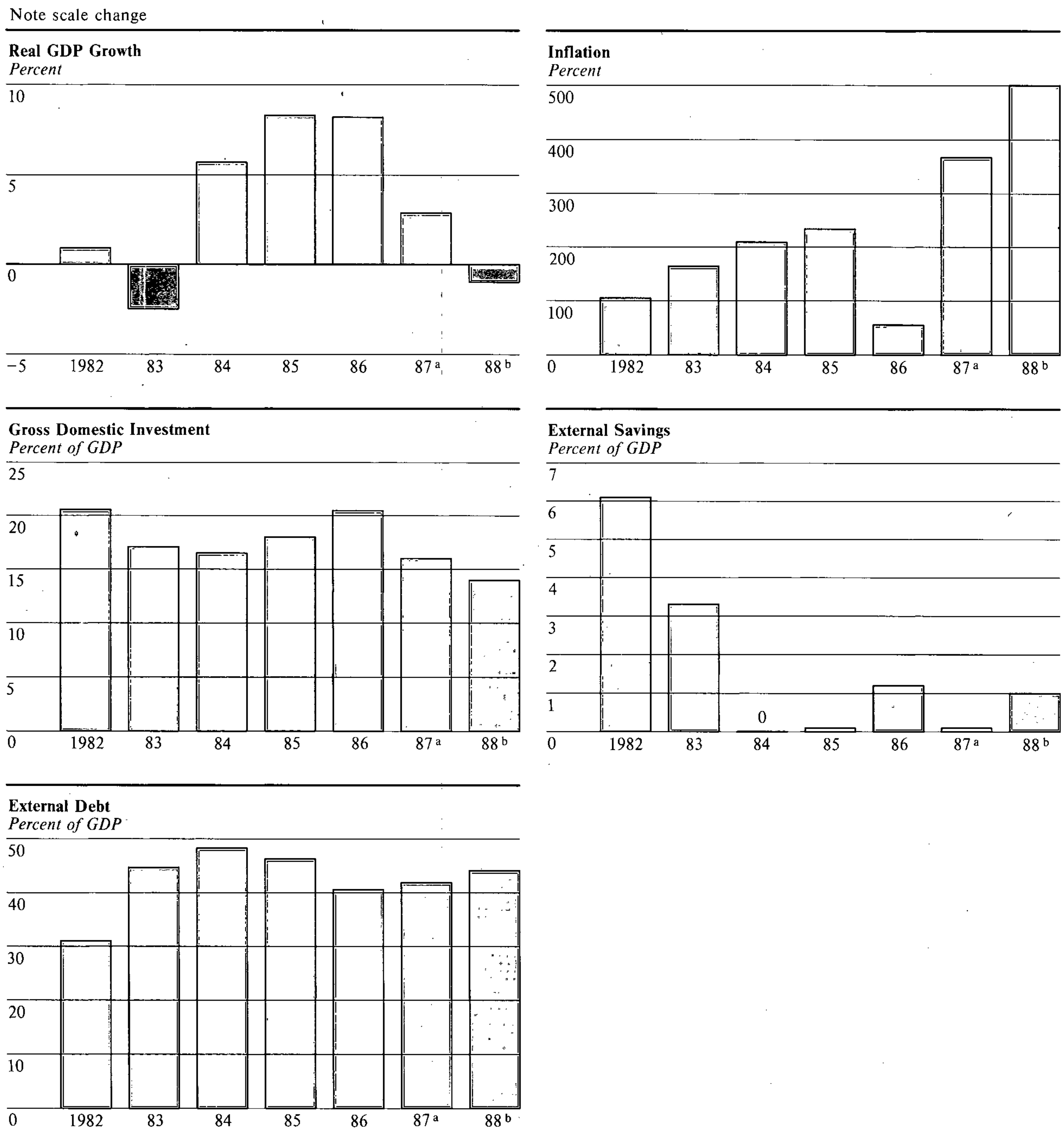
[2] The public-sector budget definition used for the purposes of this paper is the consolidated budget, which includes the operations of the Federal Treasury and of some 470 decentralized agencies, enterprises, foundations, and special funds. The figures used in this paper are adjusted for inflation. In nominal terms the deficit was over 35 percent of GDP last year.

Figure 4
Brazil: Key Economic Indicators



[a] Estimate.
[b] CIA projection.

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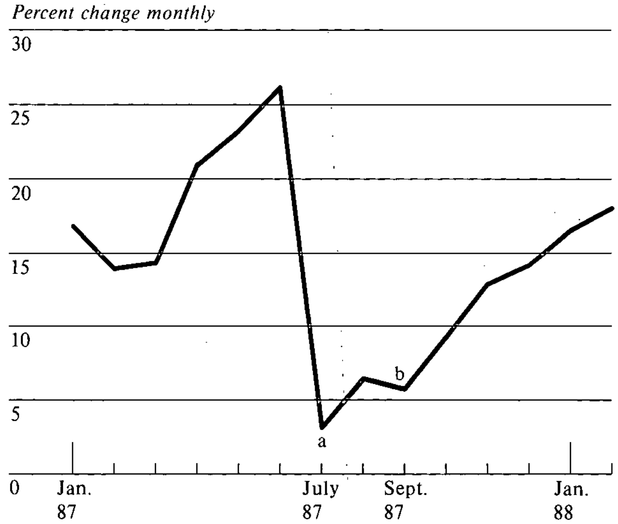
Figure 5
Brazil: Official Consumer Price Inflation



[a] Price freeze implemented.
[b] Prices decontrolled.

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Figure 6. Fiscal shock.

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In our view, by far the most likely outcome is for little progress—essentially more of what has transpired so far. Although prospects for a debt accord now appear brighter than at any time since the beginning of the moratorium, such an agreement would do little to solve domestic economic difficulties. Despite the pledge by the new economic team and Sarney to adopt more responsible policies, we believe little will be accomplished toward economic stabilization this year.

Most economists agree that, to break expectations of accelerating inflation and to restore private-sector confidence in the government, it is imperative that Brasilia immediately and sharply reduce its budget deficit. Price freezes are largely discredited, and any future attempt to control inflation using this device would be almost certain to fail.

We see little likelihood, however, of significant deficit reduction this year. On the revenue side, a package of tax hikes former Finance Minister Bresser deemed critical was largely rejected by Sarney in December 1987—resulting in Bresser's resignation. Because Brazilian law prohibits tax increases from taking effect in the year they are promulgated, this option is not available to the new economic team for 1988. In addition, rising inflation will erode tax revenues; although tax obligations are indexed, the index lags well behind inflation. Moreover, the new constitution is likely to require the federal government to transfer 20 percent of its tax collections to state and municipal governments. Finally, Brasilia will find it difficult to raise prices for public transportation, utilities, and the like sufficiently to keep pace with inflation. State enterprises were responsible for about half the federal red ink last year, largely because of inadequate tariffs.

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On the expenditure side, as earlier noted, Sarney himself is partly responsible for the failure of previous attempts at fiscal discipline. To win supporters for a presidential system of government rather than the proposed parliamentary system, the Embassy reports that Sarney promised costly political favors that he must now repay. Although he is more assured of securing a five-year term for himself now that the Assembly has set future presidential terms at five years, he is likely to continue to spread federal largess until the issue is resolved. Moreover, whatever the length of his term, the President probably will use his remaining time in office to secure projects and other political patronage for his home state of Maranhao, again dipping heavily into public coffers.

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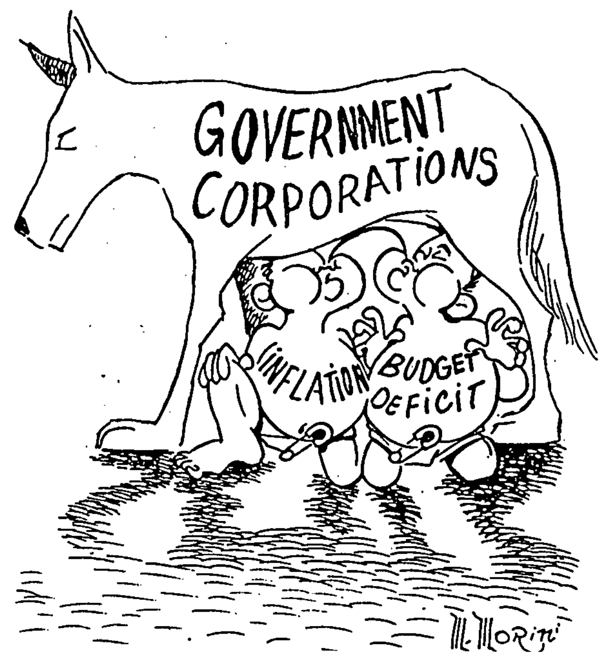


Figure 7. Government corporations feeding the budget deficit and inflation.

In addition, we believe Sarney lacks the resolve to eliminate unnecessary state-owned enterprises—Bresser's December package also included a recommendation to abolish 15 minor parastatals, which Sarney rejected, apparently fearing the resultant rise in unemployment. With prices rising, Brasilia probably will also find it difficult to keep the lid on salaries of public-sector employees this year. Wage hikes for some public-sector workers late in 1987 sent government expenditures skyrocketing. Payroll costs devoured 100 percent of federal government revenues in January. Nobrega responded with a hiring freeze and recommended temporarily halting indexation for wages, but was overruled by Brazil's influential military ministers. Finally, servicing costs on the domestic debt will probably rise as Brasilia is forced to pay ever higher interest rates to attract buyers for government bonds issued to finance the deficit.

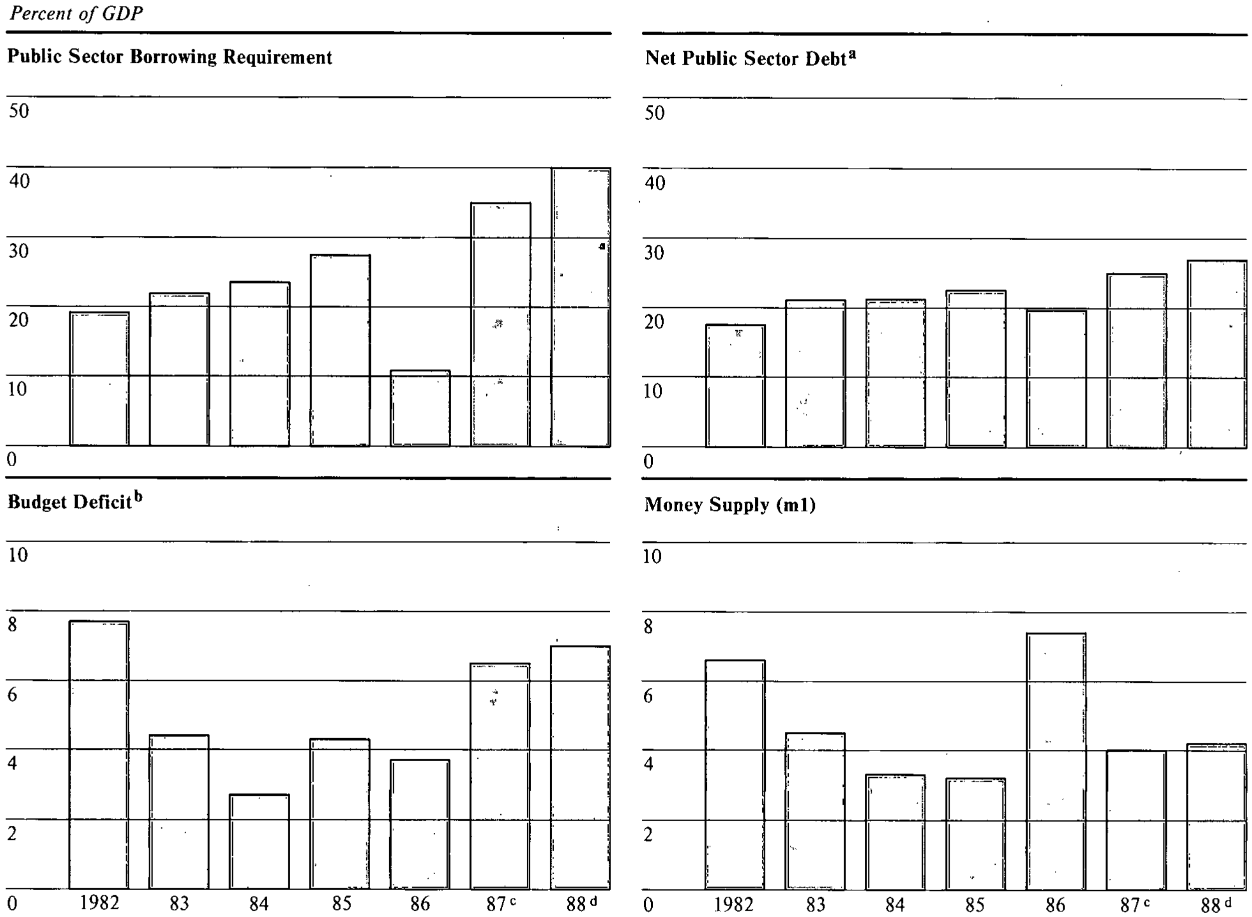
Given its lack of affiliation with a political party, the new economic team is unlikely to find guaranteed support in Congress for budget cuts, particularly if the economic slowdown that began in 1987 deepens. While extrabudgetary expenditures must now be approved by Congress—a new development this year designed to reduce the automaticity of spending hikes—we doubt this reform will result in strict fiscal control. Congressmen will probably use this opportunity to fund their own pet projects, especially since many plan to run in mayoral elections this November. Moreover, the 1988 budget is based on highly optimistic assumptions—6-percent growth and 120-percent inflation—and undoubtedly will require adjustments by midyear.

The Sarney government is likely to announce periodic spending reductions or controls this year in an attempt to reduce inflationary expectations. For example, in late February it froze borrowing by state enterprises and state and municipal governments. We believe, however, that as in 1987 many of the measures will be superficial, falling far short of what is needed, while most of those that are more substantial will not be implemented rigorously because of political constraints.

Thus, Brasilia almost certainly will not meet its goal of reducing the deficit to 3.5 percent of GDP in 1988—on the contrary, it may surpass last year's level. In turn, inflation is apt to rise, reaching 500 percent or more. Finance Minister Nobrega already is appealing to industrialists to restrain their price hikes on a voluntary basis, but economists agree that, at the current rate of inflation, such policies cannot work. The US Consulate in São Paulo reports most businessmen believe Brasilia probably will again revert to temporary price freezes to prevent inflation from rising even more than 500 percent.

Against this backdrop, domestic investment is likely to fall once again. Consumer demand probably will likewise remain slack as inflation further erodes purchasing power—retail sales fell 40 percent in January 1988 compared with the same month in 1987, for example. Producers will be likely to turn to foreign markets where possible—though sluggish world growth will temper increases of overseas sales. Nevertheless, industrial production is likely to drop this year. It fell over 8 percent in January, the sharpest one-month decline since Brazil's last economic downturn in 1983. Export revenues and government spending probably will keep Brazil from experiencing a

Figure 8
Brazil: Fiscal and Monetary Profile



[a] Domestic debt of nonfinancial public sector entities.
[b] IMF operational concept, corrected for inflation.
[c] Estimate.
[d] CIA projection.

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Campaign Against Government Excesses

A campaign against excess government spending—supported by the press, business leaders, and some politicians—has gained strength in the past year, but so far has yielded limited results. Numerous press articles have revealed that hundreds of civil servants, dubbed "maharajahs," earn huge salaries of $10,000 or more per month, over 200 times the minimum monthly wage. Several state governments, barely able to meet payrolls, have undertaken investigations to weed out employees drawing several paychecks. In late August 1987, Brasilia decreed a limit of 80 times the minimum wage on federal salaries, but a federal court subsequently declared this unconstitutional.

At the same time, business leaders have become openly critical of Brasilia's spendthrift policies, particularly when the government attempts to stem the resultant inflation through price controls. Prominent industrial associations have published several open letters to the Finance Minister and the President calling for immediate reductions in spending. Nevertheless, when former Finance Minister Bresser proposed eliminating some tax benefits and subsidies to businesses late in 1987 as part of a larger deficit reduction package, business interests successfully lobbied against it, all but eliminating the cutback from the final package.

Most recently, the Roman Catholic hierarchy has accused the government of blatant corruption. The National Conference of Bishops issued a letter to the country's 244 dioceses in late January 1988 warning that national frustration and dissatisfaction with the government had reached levels that could bring catastrophic consequences. The letter noted widespread claims that corruption is worse now than under the military regime, citing allegations of a large-scale misallocation of funds in the Planning Ministry, which had been accused of diverting money from desperately needed social welfare projects to supporters of Sarney's campaign for a five-year term. Embassy reporting indicates that the press revelations of corruption charges have provoked anger and resentment among the middle and lower classes, further eroding their confidence in the Sarney government.

severe recession this year, but no growth is likely, and a slight recession—a 1- to 2-percent decline in GDP—is possible. 25X1

As economic activity slows, unemployment will rise. Sao Paulo's largest industrial association forecasts that at least 25,000 jobs were lost during the first quarter. This, combined with inflation's erosion of wages, will further depress living standards this year and may result in increased strike activity and spontaneous public protests. Street crime, supermarket lootings, and illicit economic activity such as drug trafficking will probably also rise. 25X1

The only bright spot on the economic horizon for 1988 is the external sector. In recent weeks Brazil and its foreign creditors have narrowed their differences on several major issues relating to a multiyear debt rescheduling and new money package. Nobrega and Abreu are promising creditors that Brasilia will implement an IMF program by midyear, a course banks have long demanded but Brazil has shunned for four years. Negotiations with the Fund almost certainly will be difficult, however, particularly over the issue of the public-sector deficit. An IMF mission that evaluated Brazil's economy last year during regular annual consultations recommended that the deficit be pared to 2 percent of GDP in 1987 and eliminated in 1988. Even if Brasilia agreed to a program with such targets, it would probably fall out of compliance during the first monitoring review. 25X1

Brasilia also has conceded that its initial new money request of over $11 billion—a sum that included $3 billion to refinance the bridge loan from last year—was too high. Brazilian negotiators now agree with commercial creditors that $5.8 billion will cover their financial needs through mid-1989. The two sides have also agreed on the interest rate on new loans and the grace and repayment periods. 25X1

For their part, Brazil's major foreign creditors appear set to concede that disbursements of new money under a debt agreement need not be contingent—as is customary—on meeting IMF performance targets.

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This precedent-setting development will complicate the efforts of the creditors to gain full participation in the new money package from the more than 500 banks with loans to Brazil. Bankers report that raising the money will be difficult in an environment in which many smaller banks have written off, sold, or set aside reserves against a large share of their loans to developing countries.

With a debt agreement likely, Brazil's balance-of-payments position should improve somewhat this year. We project that the trade surplus will rise over 10 percent to $12.5 billion on the strength of a slight increase in exports, combined with a decrease—due to low internal demand and high inventories—in imports. Foreign investment probably will pick up somewhat because of a new debt-to-equity program (see inset), but nagging doubts about Brazil's ultimate political course will temper the increase. In the absence of accords with commercial and government creditors or the IMF, our projections indicate that the capital account will post another outflow of over $1 billion. It could finish the year in slight surplus, however, if such accords are reached.

Brasilia could obtain about $750 million from the IMF this year if it follows through on its promise to enter a standby program. An IMF agreement would pave the way for Brasilia to regain access to bilateral export financing, and for as much as $1 billion in project financing from Japan, but probably not before the third quarter. Lending from multilateral development banks probably will not rise much above 1987's $800 million, and net currency flows are likely to be negative because of large scheduled repayments. New lending from commercial banks will probably be limited to $1.2 billion in 1988—in addition to the $3 billion loan to refinance the 1987 bridge loan and eliminate interest arrears.

Alternative Scenarios

The Beginnings of Reform. In the event that Sarney receives a clear-cut vote of support for a five-year term, he might be motivated to break the policy paralysis that has gripped Brasilia for over a year and feel self-assured enough to carry out his promises of fiscal austerity. Were this to occur, the economy could at least start down a track toward fiscal responsibility and lower inflation. Under these circumstances,

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Prospects for New Debt-to-Equity Program

Brasilia's recently approved regulations for debt-equity conversions are less restrictive than previous proposals considered by the Central Bank, but numerous problems will probably limit their attractiveness to foreign investors. Under the new rules, debt 25X1 *will be swapped for equity through auctions by the Central Bank. Brasilia acknowledges that it intends to gain at least a portion of the secondary market discount—currently about 60 percent—for its debt through the process. Half of all swaps must involve investments in the north and northeastern regions where infrastructure and skilled labor resources are inadequate. If enforced, this restriction is likely to dampen investor enthusiasm. The regulations also prohibit investors from acquiring controlling interest in Brazilian concerns and from repatriating the investment for 12 years. Foreign investors and bankers have complained that the new rules are too restrictive, but they acknowledge that the program will probably result in an upswing in conversions from the $200 million annual level of the past two years. In* 25X1 *fact, in the first auction—held in late March 1988—$150 million was converted.* 25X1

Sarney might feel secure enough to implement some of the cuts in federal spending necessary to reduce inflationary expectations and encourage investment and to take more vigorous steps to reduce the government's role in the economy by moving forward with a privatization program. His ability to carry out such measures, however, probably would be at least partially dependent on congressional support—uncertain 25X1 at best. The new constitution may well strip him of decree-law powers, the method he has used to impose nearly all previous economic measures.

Even if he obtained congressional support, the outlook 25X1 for the economy this year would still be bleak. Budget cuts would reduce growth in the short term and would not be offset immediately by an increase in investment because rebuilding private-sector confidence would take time. Moreover, the desire to secure the election in 1989 of a favored successor probably would again induce Sarney to spend freely to gain political support, resulting in a reneging on fiscal austerity or other unpopular measures. [redacted]

Hyperinflation. As Sarney pays off political debts and continues to spend more on seeking his own five-year term, Brasilia may fail to exert any control at all over spending. Or, should Sarney begin to carry out fiscal austerity as outlined above, and it is met with a highly negative backlash from the public—who overwhelmingly favored a presidential election this year according to polls—he probably would retreat. In either case, Brasilia's ability to finance a growing deficit by selling government paper would diminish as confidence in the government's ability to continue servicing it would erode. The likely result would be an even looser monetary policy than we now foresee. [redacted]

This, in turn, could lead to hyperinflation—price rises of 50 percent or more per month. Past experience—in Bolivia and Argentina—shows that once inflation rises above 20 percent per month, inflationary psychology takes hold and the jump from 20 percent per month to 50 percent can happen very quickly, particularly in an economy as heavily indexed as Brazil's. Already, many transactions are denominated in Treasury bills that are readjusted monthly, and for some purposes, daily. In the case of hyperinflation, indexing mechanisms would not adequately protect wages and the plunge in living standards could cause massive, nationwide social discontent. [redacted]

Should the government fail to stem such economic deterioration, the growing numbers of unemployed could take to the streets. The military's concern over social order and political stability would rise sharply, and the generals would be faced with the question of whether to intervene. [redacted]

Beyond 1988

Regardless of which scenario plays out this year, daunting structural reforms will be needed to reenergize Brazil's economy. An enormous, unproductive bureaucracy has spawned a huge national debt and prohibitively high interest rates, as well as crowded out the private sector from capital markets. The total of federal, state, and municipal spending, combined 25X1 with the activities of state-owned enterprises, is estimated to amount to over half the GDP. Numerous studies show that much of the activity in the public sector could be more efficiently performed by the private sector. [redacted] 25X1

[redacted]

Nevertheless, in our judgment, an overhaul of the inefficient state enterprises is likely to be gradual at best, hindered by both a widely held public suspicion of unfettered free enterprise and an entrenched government system with many vested interests. The consequences of this are that the chronic fiscal imbalance is not likely to be rectified quickly—although it probably will be reduced from current levels—and that inflation probably will remain high. This will 25X1 check growth in the future by undermining incentives for domestic savings and investment, distorting relative prices and credit allocation, and eroding the government's ability to invest in infrastructure and education. [redacted] 25X1

In addition, the effects of paltry investment for the past five years will cause serious bottlenecks in infrastructure and industry by the turn of the decade. Less than half the $6 billion annual investment called for in a 1986 electrical-sector program has been met, and the chairman of the electric power parastatal predicts that Brazil's industrial south will experience electricity rationing by 1991. Insufficient upgrading and 25X1 maintenance of transportation and communication networks—which already lag well behind international standards—threaten to push them even further behind. Finally, certain types of steel will be in short supply by 1989 because of lack of expansion. [redacted] 25X1

Moreover, Brasilia will not be able to finance much of 25X1 its sorely needed investment from foreign resources—the course it followed to achieve rapid growth in the 1970s—in the future. Even after the current debt imbroglio is resolved, Brasilia's unilateral and unbudging stance with creditors over the past year probably has soured for the indefinite future the attitudes of many bankers vis-a-vis new lending. Brazil was once seen as one of the only countries in 25X1 the region where banks could realistically hope to recoup their loans and one of the few that would be eligible for voluntary lending in this century. Many bankers now admit that they are eager to divest themselves of all Latin debt, including Brazil's. While foreign direct investment probably will rise from recent lows, it will not play the role that foreign loans did in Brazil's past development.

Brazil has closed its markets to most advanced technology during the past few years through laws that prohibit most imports, foreign investment, and copyright protection in the computer industry. The subject of a bitter trade dispute between Washington and Brasilia, these laws are undoubtedly stymieing investment plans in many industries, which now utilize computer-related technology throughout the production process. The products of domestic computer manufacturers—which the law is designed to protect—lag well behind international standards. Outdated technologies already have caused Brazil's textile industry to fall far behind those in Asia—the owner of a large textile plant in Brazil estimates that the sector would need to invest $4 billion annually for the next 15 years to put it on an equal footing with its Asian competitors. Unless Brasilia rescinds or substantially liberalizes these laws, its industrial sector risks becoming technically obsolete, producing products that cannot compete in foreign markets.

Finally, Brazil suffers from serious social inequities that work to undermine the productivity of its human resources. The fruits of rapid development during the 1960s and 1970s were not shared by a sizable majority of the population. Indeed, income distribution, reported by the World Bank to be the world's most inequitable, has become even more skewed during the past 20 years, with 10 percent of the population receiving 50 percent of the income today. In addition, over one-third of the population earns less than subsistence incomes and two-fifths have no access to a sewage system. Malnutrition is widespread, particularly in the northeast where infant mortality rates rival those of the worst affected areas in Africa. Brasilia has traditionally touted rapid economic growth as the primary way to overcome poverty. President Sarney has also increased spending on social welfare projects but without finding noninflationary sources of financing.

Thus, whatever 1988 brings, Brazil's next president will face immense economic and social hurdles—far beyond the immediate urgent problems of escalating inflation and a debt moratorium—that will delay the country's ability to realize its potential over the long term and limit growth prospects in the medium term. 25X1

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Implications for the United States

Brasilia's economic policies probably will continue to create strains in its relationship with the United States. Considerable friction has already resulted from Brasilia's tough restrictions on market access for US computer firms and its often intransigent stance on debt. Other differences loom, especially over intellectual property rights and patent protection. Moreover, although moderates in the Constituent Assembly are attempting to head off protectionist economic provisions in the draft constitution, some of the measures likely to remain will reduce US market access and lead to future disputes over trade and investment. 25X1

Brasilia believes it has made enough concessions on its information technology policy to prevent US retaliation against Brazilian imports, and a review of initial bilateral discussions this year indicates that it is not likely to be any more forthcoming on textiles, pharmaceuticals, pirated videocassettes, and steel. In our view, Brazil will continue to hew to its hardline position—contrary to US interests on most issues—during the ongoing General Agreement on Trade and Tariffs (GATT) talks. The Sarney government can be expected to continue pointing to its political difficulties in an effort to induce Washington to drop or attenuate its economic complaints. 25X1

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In addition to aggravating economic ties within the bilateral relationship, Brazil's efforts to respond to economic difficulties have the potential to create more strains on the diplomatic front. As financial constraints tighten further this year for Brazil's financially troubled arms producers, they will be both more

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aggressive in pushing arms sales and less concerned about who their buyers are, as has been demonstrated by Brazil's renewed willingness to negotiate a major arms contract with Libya. Brasilia may also look more to the Soviet Union or other Bloc countries for economic cooperation. It already has asked for Soviet assistance in financing a railway, a project that a multilateral development bank rejected. [redacted] 25X1

If Sarney is successful in securing a clear-cut vote of confidence for a five-year mandate, he may be more willing to override the nationalistic policy recommendations from officials in the Foreign Ministry and be more forthcoming on bilateral and multilateral trade disputes. Conversely, a rapid economic plunge that may result from deeper policy paralysis would seriously jeopardize agreements with creditors and the IMF, causing continued problems for US banks. [redacted] 25X1